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Fiscal impetus and the Great Recession

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The economic effects of the profound recession that struck the United States from December 2007 through June 2009 (aptly dubbed the “Great Recession”) are well known: falling employment, rising unemployment, less consumer spending, and a host of other contractionary consequences, as in other U.S. recessions—but deeper and longer lasting. Less well known is how, and even whether, the federal, state, and local governments’ fiscal policy responses to the recession met the challenge posed by the recession. In “Measuring fiscal impetus: the Great Recession in historical context,” Leslie McGranahan and Jacob Berman (*Economic Perspectives*, Federal Reserve Bank of Chicago, third quarter, 2014) attempt to answer this question in as simple, yet illuminating, a manner as possible. Avoiding the more complicated methods of some economists, these authors present a simple mathematical formula that measures what they call *fiscal impetus*, or “the combined effect of purchases, taxes, and transfers across all levels of government on [economic] growth.” Using this formula, the authors show that the government’s fiscal policy had a somewhat more expansionary effect during the Great Recession than it had during other recessions. However, fiscal policy was *far more* contractionary during the subsequent recovery than it was during other recessions—to the point that its usefulness as a tool for stimulating economic growth in the near future is questionable.

Starting with the recessionary period itself, McGranahan and Berman show that fiscal policy was more expansionary during the Great Recession than in any other recession since 1960. The added stimulus to the economy came mostly from falling taxes and rising transfer payments due to the Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009. The former gave $113 billion in tax rebates to individuals and couples meeting specific income criteria. The latter cut personal tax rates and provided more money for defense and, to a lesser extent, for various transfer payments. But the effect did not last long: McGranahan and Berman demonstrate that, as the recession turned into recovery, the contraction in economic growth resulting from reduced fiscal spending was massive and, up to that time, unheard of. In contrast, most other recoveries did not encounter reduced fiscal spending. Government purchases shrank in almost every quarter from the trough of this recession until 2012. Transfer payments, though growing, rose at a rate below the average for all preceding recessions since 1960. And the net effect of tax policy during the recovery was near zero. Together, these trends show both that tax revenues did not increase nearly as much as they usually do in recoveries and that the purchasing power of consumers was relatively weak. In sum, the U.S. government pursued an expansionary fiscal policy during the Great Recession and a counterintuitive contractionary policy in the recovery that has followed. If matters continue that way, fiscal policy may lose its utility as a means of sparking economic growth.